No. 15031

In the United States Court of Appeals for the Ninth Circuit

ESTATE OF HERBERT B. MILLER, Deceased, UNITED STATES NATIONAL BANK OF PORTLAND, (Oregon), Administrator, d.b.n., c.t.a., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
HILBERT P. ZARKY,
GRANT W. WIPRUD,
Attorneys, Department of Justice,
Washington 25, D. C.

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 32-56) are reported at 24 T.C. 923.

JURISDICTION

These petitions for review (R. 7, 11, 59-61) involve federal income taxes for the calendar years 1946 and 1947. Taxpayer died on February 13, 1948. (R. 23.) On February 28, 1950, and August 7, 1950, respectively, the Commissioner of Internal Revenue mailed to taxpayer's former executor—who was thereafter ap-

pointed administrator d.b.n., c.t.a. (R. 24)—notices of deficiency for the years 1946 and 1947, in the amounts, respectively, of $1,882.27 and $3,982.35 (R. 25). Within ninety days after the mailing of the first notice of deficiency and on May 29, 1950, taxpayer's former executor filed a petition with the Tax Court for a redetermination of the deficiency for 1946. (R. 3, 12-17.) Within ninety days after the mailing of the second notice of deficiency and on October 19, 1950, taxpayer's former executor filed a petition with the Tax Court for a redetermination of the deficiency for 1947. (R. 8.) The cases were consolidated on October 12, 1954. (R. 6, 10.) The decisions of the Tax Court were entered on August 24, 1955. (R. 7, 11, 57-58.) The cases are brought to this Court by petitions for review filed on November 17, 1955. (R. 7, 11, 59-61.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

Pursuant to a prearranged plan, members of a partnership organized a corporation, paid a nominal amount for all its stock, which was no par and of a nominal declared value, and thereafter transferred to the corporation all of the operating assets of the partnership plus $50,000 in cash in exchange for interest-bearing notes of the corporation.

1. Did the corporate notes represent capital investments rather than bona fide creditor-debtor transactions, so that the transfer of the partnership assets to the corporation constituted part of a nontaxable exchange under Section 112 (b)(5) of the Internal Revenue Code of 1939?

2. Did payments of purported interest and principal on the notes constitute taxable dividends, within the meaning of Section 115 (a) of the Internal Revenue Code of 1939?

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) [As amended by Sec. 213 (c) of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Exchanges Solely in Kind.*—

* * * * *

> (5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under subsection (k) it is not to be considered

as "other property or money") shall be considered as stock or securities received by such transferor.

* * * * *

(26 U.S.C. 1952 ed., Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b)(5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

(26 U.S.C. 1952 ed., Sec. 113.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 115.)

STATEMENT

The facts material to this appeal, as found by the Tax Court (R. 34-41), may be summarized as follows:

Prior to June 1, 1946, taxpayer Herbert B. Miller and his two brothers, Ernest and Walter, were equal partners in the paint manufacturing and marketing business, doing business as Miller Paint Company (hereinafter called the partnership). The partnership assets consisted of personal property, accounts receivable and cash; its premises were rented from another partnership composed of the same brothers. (R. 34-35.)

Sometime in 1943 or 1944 Ernest and Walter were informed that taxpayer had cancer, and could live only a few years longer. It is not apparent whether taxpayer ever became aware of his condition. Ernest and Walter became concerned over the problem of continuity of the business in case of the death or incapacity of a partner. Without revealing anything to the taxpayer relative to his physical condition, they convinced him that some steps should be taken to insure such continuity. (R. 35.)

Taxpayer was married and had children; Ernest was married but childless; and Walter was unmarried. The three brothers desired an arrangement whereby, on the death or incapacity of a partner, the business could carry on free of interference, regardless of possible complications in the eventual probate of an estate; and whereby an estate could be created for the benefit of a decedent's family. In addition, Ernest wished to leave his share of the business to some employees without disturbing management and control. (R. 35.)

In late 1945 the partners were advised by counsel that the corporate form would best suit their purposes. They decided to form a corporation and transfer to it the assets necessary to carry on the business, but to take the cash of the partnership into their hands individually. In the years immediately prior to June 1, 1946, earnings had been high, and no evidence was presented suggesting doubts at that time that the prosperity of the business would continue. (R. 36.)

In accordance with the plan to incorporate the business, Miller Paint Co., Inc. (hereafter called the corporation), was organized under the laws of Oregon on or about May 13, 1946. Total authorized capital consisted of 300 shares of no par stock. Oregon law re-

quires that a corporation with no par stock have a capital investment of at least $1,000. Each partner subscribed for 100 shares at a stated value of $3.50 per share, and paid the stated value in cash from his respective personal bank account. (R. 36.)

The corporate charter was received on May 18, 1946. The stock was issued on May 20; and on the same day, the first meeting of the board of directors was held. It was resolved that the corporation borrow $50,000 from the three partners and execute a three-year promissory note therefor bearing interest at five percent. This resolution was carried out on June 1, 1946. Thereafter, at the second meeting of the board on June 3, it was resolved that the corporation purchase from the partners, at inventory value, substantially all the operating assets of the partnership. The fair market value of such assets was $86,622.49; and a note in such amount was issued to the partners in their joint names, payable in annual installments of no less than $20,000, and bearing interest at five percent. Another resolution called for the purchase by the corporation of certain intangible assets of the partnership, subject to liabilities. The net fair market value thereof was $37,948.77, and a note in that amount was issued to the partners in their joint names, payable six years from date and bearing interest at five percent. As security for the two notes the corporation executed and delivered a chattel mortgage. (R. 36-37.)

The partners at all times considered their interests in the partnership assets and in the corporate notes received therefor to be equal. (R. 37.)

As a result of the above transactions, the corporation acquired a substantial amount of cash and the bus-

iness assets of the partnership, and succeeded to the partnership's business. The tangible assets transferred included inventory, machinery and equipment, and furniture and office equipment. The adjusted basis of the partnership in these assets on June 1, 1946, was less than the fair market value thereof. The partnership reported a gain in the amount of $6,683.68, which was proportionally reflected and reported as long-term capital gain on the individual returns of the partners. The intangible assets transferred consisted of petty cash, accounts receivable, and unexpired insurance; and were transferred subject to accounts payable. (R. 38.)

On July 31, 1946, the board of directors met and resolved that the three corporate notes theretofore issued be canceled, and that in lieu thereof new notes be issued separately to each partner in the amount of his one-third interest. Accordingly, in lieu of the notes for $50,000 and $37,948.77, which were canceled, each partner received a new note for $28,874.16. Of the new notes issued, the latter were payable in annual installments of no less than $6,666.66, while the former were payable six years from date. All bore interest at five percent. By resolution of the directors, the previously executed chattel mortgage became security for the payment of the new notes. The books of the corporation have at all times carried the amounts of the notes as a "Notes Payable" liability. (R. 39.)

In 1946 and 1947 taxpayer received amounts designated as payments on the principal of the note for $28,874.16 held by him. These payments amounted to $7,500 in 1946 and $10,000 in 1947. Equal amounts were paid to Ernest and Walter on their respective notes, and a corresponding reduction in the "Notes

Payable" account was taken on the books of the corporation. (R. 39.)

Despite substantial earnings, the corporation has never formally declared a dividend. (R. 39.)

Ultimate facts found by the Tax Court (R. 40-41) may be summarized as follows:

The principal purpose in forming the corporation was to transfer to it the business conducted up to that time by the partnership together with a substantial amount of cash. No material change in the investment of the partners was contemplated, except that they would now be carrying on the same business in corporate form. (R. 40.)

No business reason dictated the formal method of capitalization undertaken. The issuance of stock with a declared value of $1,050 was viewed by the partners as merely the first step in a single plan, the over-all objective whereof was to transfer the paint business to the corporation. The various steps outlined above, including the transfers of tangible and intangible partnership assets, were in fact parts of a single integrated transaction. (R. 40.)

The assets and cash transferred to the corporation were intended by the partners as a permanent investment. There was no bona fide intention to effect a sale or dispose of the business in any other manner. The notes did not create a bona fide debtor-creditor relationship; the assets and cash transferred constituted in substance, though not in form, the consideration paid for the stock. (R. 40.)

The payments at issue (which purported to be payments on the notes held by taxpayer) were received by taxpayer as a stockholder, not as a creditor; and con-

stituted taxable dividends to the extent of available earnings and profits. (R. 40-41.)

The integrated transaction described above was in substance a transfer of property solely in exchange for stock of the transferee corporation, within the meaning of Section 112(b)(5) of the Internal Revenue Code of 1939, which withholds recognition of gain to the transferors; and the basis of the corporation is the same as that in the hands of the transferors prior to the exchange, under Section 113(a)(8) of the Internal Revenue Code of 1939. (R. 41.)

SUMMARY OF ARGUMENT

Taxpayer and his brothers decided to incorporate their partnership business. They organized a new corporation; transferred to it partnership assets other than cash in exchange for notes totaling over $124,000; advanced $50,000 in cash as a purported loan, taking another note therefor; and paid $1,050 in cash for all of the stock of the corporation. They withheld the partnership's cash on hand, totaling over $98,000; and thus, in effect, the corporation received the total assets of the partnership less about $47,000 in cash—i.e., the difference between the cash in hand withheld and the cash transferred.

The underlying question in this litigation is whether a bona fide debtor-creditor relationship arose upon the issuance of the corporate notes in question. The Tax Court answered this question in the negative; and we submit that its finding was amply warranted by the record.

A true creditor interest must reflect an intention to subject the corporation to an absolute obligation, and to enforce such obligation in accordance with its terms;

whereas a true stockholding interest reflects the commitment of assets to the fortunes of the business, with the hope of reaping profits and, conversely, the expectation of sharing losses. These are the controlling criteria—not the forms resorted to by the parties.

In the case at bar, the avowed intention of the brothers was to insure continuity of the business. This intention is consonant only with the view that the assets represented by notes constituted capital investments; for it is clear that enforcement of the notes totaling $174,000, in the event the corporation was unable to pay them, would have resulted in liquidation of the business or heavy mortgages at prohibitive cost. It is not to the point, of course, that the earnings of the corporation were high enough to pay the notes in accordance with their terms. The question is whether the notes created an *absolute* obligation, repayable in *any* event; and this question can only be answered by reference to possible adversity as well as to possible prosperity. If the intention is pay the notes out of earnings, and only so far as earnings make payment possible, then the notes reflect capital investments. And we submit that this was clearly the intention of the Miller brothers, as the Tax Court found.

Since, then, all of the assets transferred constituted capital investments, it follows that there was an exchange of property solely for stock or securities within the meaning of Section 112 (b)(5) of the Internal Revenue Code of 1939; and hence that no gain or loss is recognized on the exchange. It follows further that corporate distributions designated as payments of principal on the purported notes were, in reality, taxable dividends under Section 115 (a) of the 1939 Code.

ARGUMENT

I

The Tax Court Was Amply Warranted by the Record in Finding as a Fact that No Valid Debtor-Creditor Relationship Arose upon the Issuance of the Corporate Notes in Question

This litigation draws into question the nature of certain transactions which took place in 1946, whereby the business of a partnership became the business of a closely-held corporation. Prior to May, 1946, the business was conducted by taxpayer Herbert B. Miller in partnership with two brothers. On May 13, 1946, the partners organized a corporation under the laws of Oregon, which require that a corporation with no par stock have a capital investment of at least $1,000. The authorized capital of the new corporation consisted of 300 shares of no par stock. The partners purchased 100 shares each of this stock at the stated value of $3.50 per share, with funds from their personal bank accounts; and thus for an investment of $1,050 became owners of all of the corporation's stock. Within a few days thereafter, the operating assets of the partnership were transferred to the corporation. This transfer was cast in the form of a sale, the Miller brothers receiving two interest-bearing notes totaling $124,571.26 which were issued to them in their joint names. The brothers also advanced $50,000 in cash to the corporation, purportedly as a loan and receiving an interest-bearing note therefor. (R. 36-37.) As to the source of this $50,000, the record discloses that the partnership had on hand at the time of dissolution $98,720.15 in cash which was owned equally by the partners (Ex. 1-A); and that this cash was taken out by the partners

prior to the transfer of the partnership assets to the corporation (R. 44).

There are two specific issues in this case. The first is whether the exchange of partnership assets and cash for no par stock and corporate notes constituted, in reality, a tax-free exchange under Section 112 (b)(5) of the 1939 Code, *supra.*[1] The second is whether distributions by the corporation to taxpayer in 1946 and 1947, purportedly as payments of principal upon one of the notes issued for the partnership assets, were in reality taxable dividends to the extent of available earnings and profits under Section 115 (a) of the 1939 Code, *supra.*

Underlying these specific issues is a broader question: did the corporate notes reflect bona fide debts or capital investments? This question is one of fact relating to the intent of the parties, which is to be ascertained from all relevant facts and circumstances. *Earle* v. *W. J. Jones & Son,* 200 F. 2d 846 (C.A. 9th); *United States* v. *Title Guarantee & Trust Co.,* 133 F. 2d 990 (C.A. 6th); *Bowersock Mills & Power Co.* v. *Commissioner,* 172 F. 2d 904 (C.A. 10th); *Wetterau Grocer Co.* v. *Commissioner,* 179 F. 2d 158 (C.A. 8th); *Commissioner* v. *Meridian & Thirteenth R. Co.,* 132 F. 2d 182 (C.A. 7th); *Rowan* v. *United States,* 219 F. 2d 51 (C.A. 5th); *Matthiessen* v. *Commissioner,* 194 F. 2d 659 (C.A. 2d).

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[1] In its final return the partnership reported a capital gain of $6,683.68 on the purported sale of the partnership assets to the corporation; and this was proportionally reported as long-term capital gain in the partners' individual returns. (R. 38.) The Commissioner subsequently determined that the distributive share of capital gain reported by taxpayer should be eliminated from income, because no gain or loss should be recognized upon the transfer of the partnership assets to the corporation. (R. 20.)

As this Court said in *Washmont Corp.* v. *Hendricksen,* 137 F. 2d 306, 308:

> Not any of the cases which have decided this issue as to whether certificates are evidences of debt or stock ownership comprehend all the points that arise in this case. The decision in all cases has turned on the facts of the individual case. In each case, the court must determine whether the transaction was an investment in stock or a loan to the corporation.

In the case at bar, the Tax Court found as a fact (R. 40) that, in transferring the partnership assets and cash to the corporation, the Miller brothers intended to make a capital investment; and hence that the corporate notes did not reflect a bona fide debtor-creditor relationship. In making that finding the Tax Court had before it not only stipulated facts and exhibits but testimony of taxpayer's witnesses. (R. 80-135.) The burden is upon the taxpayer to show that this finding is clearly erroneous. *Grace Bros.* v. *Commissioner,* 173 F. 2d 170 (C.A. 9th). We submit that the finding is not only free from clear error, but is amply warranted by the record. Before turning to the facts of the case, however, it is important to clarify just what role intention plays in cases of this kind, under the decided cases.

In *Wilshire & West. Sandwiches* v. *Commissioner,* 175 F. 2d 718, this Court quoted with approval the following language from *Commissioner* v. *Meridian & Thirteenth R. Co.,* 132 F. 2d 182 (C.A. 7th) (p. 721):

> It is often said that the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks

of the venture, while the former seeks a definite obligation, payable in any event.

Similarly, in *United States* v. *Title Guarantee & Trust Co.*, 133 F. 2d 990 (C.A. 6th), the court declared, italicizing part of its language for emphasis (p. 993):

> *The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit.* The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them.

In the application of these criteria, it is well settled that labels and forms are not conclusive, but that the true intention of the parties is to be determined from *all* of the relevant facts and circumstances. Thus it is said in *Schnitzer* v. *Commissioner,* 13 T.C. 43, 60-61, affirmed, 183 F. 2d 70 (C.A. 9th), certiorari denied, 340 U.S. 911—

> in deciding whether or not a debtor-creditor relation resulted from advances, the parties' true intent is relevant * * *. Bookkeeping, form, and the parties' expressions of intent or character, the expectation of repayment, the relation of advances to stockholdings, and the adequacy of the corporate capital previously invested are among circumstances properly to be considered, *for the parties' formal designations of the advances are not conclusive, * * * but must yield to "facts which even indirectly may give rise to inferences contradicting" them.* (Emphasis added.)

Accord: *United States* v. *Title Guarantee & Trust Co., supra,* p. 993; *Washmont Corp.* v. *Hendricksen, supra; John Wanamaker Philadelphia* v. *Commissioner,* 139 F. 2d 644 (C.A. 3d); and *Helvering* v. *Richmond, F. & P.R. Co.,* 90 F. 2d 971, 975 (C.A. 4th).

And, finally, the courts are agreed that where inadequacy of capitalization is extreme, substantially all of the assets of the business being transferred to the corporation in the guise of a sale or loan, that is one of the significant facts to be weighed by the fact finder in its determination whether the form of the transaction is to be disregarded and the transfers treated as capital investments.[2]

Thus in *Schnitzer* v. *Commissioner, supra,* the court said (p. 62):

> A corporation's financial structure in which a wholly inadequate part of the investment is attributed to stock while the bulk is represented

[2] Petitioner contends that the ratio of 174 to 1, as between the face value of the notes and the stated value of the stock in the case at bar, is not the true ratio between the value of the notes and the stock because, allegedly, the stock really had a fair market value at the time of issuance of $104,000, rather than $1,050. Petitioner reaches this result by resorting to a method of capitalizing earnings. (Br. 32-33.) But in taking this position, petitioner ignores—and contradicts—the position taken by the Miller brothers themselves in reporting the "sale" of the partnership assets to the corporation in their 1946 returns. In those returns the brothers represented that the fair market value of *all* business assets transferred (other than cash) was the amount of $124,571.26; and measured their alleged capital gain as the difference between this amount and the depreciated book value of the assets. (Exs. 1-A, 2-B.) It appears, then, that the Miller brothers did not consider that any such values were transferred to the corporation as are now contended for by petitioner. In the absence of any other direct evidence as to the value of the business assets at the time of the exchange, the Tax Court was surely warranted in finding that the value of the stock was its stated value of $1,050.

> by bonds or other evidence of indebtedness to stockholders is lacking in the substance necessary for recognition for tax purposes, and must be interpreted in accordance with realities.

Put another way in equally cogent language, it is said in *Dobkin* v. *Commissioner,* 15 T.C. 31, 33, affirmed, 192 F. 2d 392 (C.A. 2d):

> When the organizers of a new enterprise arbitrarily designate as loans the major portion of the funds they lay out in order to get the business established and under way, a strong inference arises that the entire amount paid in is a contribution to the corporation's capital and is placed at the risk in the business. *Cohen* v. *Commissioner,* 148 Fed. (2d) 336; *Joseph B. Thomas,* 2 T.C. 193.

See also: *1432 Broadway Corp.* v. *Commissioner,* 4 T.C. 1158, affirmed, 160 F. 2d 885 (C.A. 2d); *Swoby Corp.* v. *Commissioner,* 9 T.C. 887; *Janeway* v. *Commissioner,* 147 F. 2d 602 (C.A. 2d); *Matthiessen* v. *Commissioner,* 194 F. 2d 659 (C.A. 2d); *Bair* v. *Commissioner,* 199 F. 2d 589 (C.A. 2d); *Bachrach* v. *Commissioner,* 18 T.C. 479, affirmed *per curiam,* 205 F. 2d 151 (C.A. 2d); *Earle* v. *W. J. Jones & Son,* 200 F. 2d 540 (C.A. 9th); *Sogg* v. *Commissioner,* 194 F. 2d 540 (C.A. 6th); cf. *Rowan* v. *United States,* 219 F. 2d 51 (C.A. 5th).

Turning, then, to the facts of the case at bar, we freely concede at the outset that the formal criteria of indebtedness were satisfied by the steps which taxpayer and his brothers took in setting up the purported sales and loan to the corporation. We do not

dispute what petitioner repeatedly calls (Br. 14, 16) the "impeccable" form of the notes, the bookkeeping entries, and so forth. And when petitioner asks (Br. 18) "as a matter of form, what more could the taxpayer have done to legally create an 'indebtedness' * * *?" we answer, "Nothing". Indeed, where, as here, the parties deliberately adopt certain forms with the express purpose of achieving desired tax results, it is not surprising that the forms should be impeccable. But the form is not at all controlling in determining the application of the relevant statutory provisions. It is the intention of the parties that controls as, indeed, taxpayer concedes. (Br. 18-19.) And we submit that the facts of record, *aliunde* the forms employed, clearly demonstrate that the intention of taxpayer and his brothers, under established criteria, was to make a capital investment.

Taxpayer and his brothers formed the new corporation, not to launch a new business or a modified business, but to continue in corporate form the same business they were conducting as partners. They transferred to the new corporation business assets totaling over $174,000—substantially all the assets of the partnership save for part of the cash on hand. No new capital was infused into the business, unless the nominal amount of $1,050 paid for stock be so considered. And even the $1,050 was hardly new capital in any substantive sense. The Miller brothers retained over $98,000 of the partnership's cash on hand; "loaned" $50,000 in cash to the corporation; and paid $1,050 in cash for all the stock. Thus, in effect, the corporation received the assets of the partnership less about $47,000 —i.e., the difference between the cash retained and

the cash transferred, which the Miller brothers apparently decided was not needed in the operations of the business. In short, the cash assets of the business were somewhat curtailed upon incorporation—not expanded. In all other respects the assets remained virtually the same. And the Miller brothers received equal interests in the stock and purported notes of the corporation, just as they had been equal partners.

Under these circumstances, there is surely only one realistic conclusion to be drawn. Just as the Miller brothers *qua* partners were equal owners of the business and all its assets, so *qua* stockholders they continued to be equal owners thereof. Petitioner's arguments to the contrary, in essence, come down to this contention: that the Miller brothers continued as owners of the *business* (through purchase of the stock for a nominal amount) but not as the equitable owners of the assets of that business—the machinery, equipment, inventory, accounts receivable, and so forth, which constituted such assets. This position is untenable.

A true creditor interest must reflect an intention to subject the corporation to an absolute obligation, and to enforce such obligation in accordance with its terms; whereas a true stockholding interest reflects the commitment of assets to the fortunes of the business, with the hope of reaping profits and, conversely, the expectation of sharing losses.

Of course the intention of the parties is the ultimate test. But where certain overt acts have necessary legal consequences, the only question is whether those acts have been performed in accordance with the intention of the parties. Here, as we shall see, the parties were

rightfully held to have intended to have assumed the risks of proprietors and not (despite the forms used) to occupy the position of creditors.

In committing the assets of their business to the new corporation, the Miller brothers naturally hoped to reap profits from the continued operation of the business. Petitioner concedes that taxpayer expected not only the interest but the principal of the notes to be paid out of earnings. (Br. 41.) It is not conceded that taxpayer intended such payments to be contingent upon earnings; but it appears quite clear, in fact, that the payments of principal in 1946 and 1947 were *geared* to earnings, just as would have been true if the profits had been used to pay dividends. The note upon which the payments were made called for annual payments of no less than $6,666.66, thus setting a minimum but no maximum; and taxpayer received $7,500 in 1946 and $10,000 in 1947, designated as payments on principal. (R. 39.) These payments reflect the fact noted by petitioner (Br. 41) that the hopes of high profits were rewarded and hence that the purported loans "were being repaid more rapidly than the terms of the notes provided * * *."

But would the Miller brothers have enforced the notes according to their letter, had the business unexpectedly fallen upon hard times? Surely not. Where substantially all the assets of a corporation are represented by notes, and the corporation defaults, literal enforcement of the notes must have one of two results, as noted in *Mullin Building Corp.* v. *Commissioner,* 9 T.C. 350, 355, affirmed *per curiam,* 167 F. 2d 1001 (C.A. 3d). Either the corporation must be liquidated, or its assets must be so heavily mortgaged as to siphon

off a large part of the corporate earnings in interest on the mortgage. And hence where the holders of the notes are also the stockholders, as the court said in *Mullin,* literal enforcement of the notes (p. 355)—

> would be too irrational * * * to merit * * * contemplation. * * * Such a course is not within the realm of sane business practice and we are convinced that it was not intended.

And the Tax Court here made a specific finding, stating (R. 45-46)—

> we have no doubt, from a reading of the entire record, that no payment was ever intended or would ever be made or demanded which would in any way weaken or undermine the business.

In this respect, we believe that it is most significant that the very purpose which impelled the brothers to incorporate their partnership business, can not be reconciled with the contention that, after incorporation, they no longer possessed an ownership interest in the business assets, but are to be treated as creditors to the extent that they caused their corporation to issue "notes" instead of stock. That is, it is undisputed that the principal purpose of incorporating the partnership business was to permit a continuity of the business so that the death or incapacity of one of the brothers would not interfere with the business being carried on, and also so that the brothers could create an estate for the benefit of their families in case of death. (R. 35.) But that purpose would have been subject to frustration rather than fulfillment if

the most substantial part of the business assets had been sold in reliance on the corporation's promise to pay the self-styled notes which were issued. If the business had experienced losses, rather than profits, payment of the principal of the notes at maturity, or even the payment of interest on the notes, would have caused a disruption of the corporation's business or of the ownership interest in the business which the parties sought to perpetuate. This, of course, would have been the precise opposite of what the parties set out to accomplish.

It is true that the business prospered and this eventuality never materialized. But businessmen do not arrange their affairs with blind optimism. The possibility of business reverses is always present.[3] And the acid test of the relationship would come with business reversals, not with business profits. Assuredly, the Tax Court does not commit reversible error where, as here, it concludes that the parties did not truly intend to create a corporate debt which would be payable at all events when their very purpose was to establish a business enterprise which would not be subject to such disruptive forces. This conclusion results from the fact finder having accepted the parties' own representations respecting the objectives which they sought to achieve and in rejecting their conten-

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[3] It is not to the point, of course, that the Miller brothers hoped that their business would continue to earn high profits, and that this hope was fulfilled. If this were a material factor in these cases, then those taxpayers who guessed right as to future profits would receive them *qua* creditors, while those taxpayers who guessed wrong—and, inevitably, refrained from enforcing their notes—would be viewed differently for tax purposes. But it is not a matter of hindsight. The tests relate to intention at the time of incorporation.

tion that the form which they adopted truly reflected that intent. As the Tax Court said (R. 47-48):

> * * * in the light of all the surrounding facts and circumstances, it is not reasonable to accept the absoluteness in form of the notes at face value. To do so would be to impute a willingness on the part of the partners to endanger their chief source of livelihood.

It has already been shown that the brothers could not have intended a fixed obligation. They hoped for high profits, and intended payments on the notes to be geared to and paid out of such earnings; but absent the necessary profits, they surely would not have enforced the notes at the cost of liquidating the corporation or mortgaging all its assets. The payment of the notes being thus contingent upon profits, the taxpayer's family stood in no better position than if all of the assets had been allocated to stock.

Petitioner relies particularly upon several cases in this connection including *John W. Walter, Inc.* v. *Commissioner,* 23 T.C. 550; *Tauber* v. *Commissioner,* 24 T.C. 179; and *Perrault* v. *Commissioner,* 25 T.C. No. 55. These cases are clearly distinguishable in significant ways. In *John W. Walter, Inc.,* the taxpayer—sole proprietor of a small electrical appliance business—incorporated his business, transferring assets totaling $25,000 to the corporation and issuing stock therefor. There is no indication that the assets exchanged for stock did not comprise all, or substantially all, of the assets of the business as of the time of incorporation. This, without more, under the principles discussed above, made taxpayer the proprietor in fact as well as in name of the corporation, regardless of

the large expansion of the business contemplated and effected by the subsequent transfer of a distributorship to the corporation.

In *Tauber,* the business assets transferred from a partnership to a new corporation had a fair market value at the time of transfer considerably in excess of book value, as the partners well knew. The court found that the partners intended to transfer the full value of the partnership assets; that the excess of fair market value over book value was about $150,000; and that this excess was allocable to stock, since the partners had taken corporate notes only for $209,000—which represented the book value of the assets. In the case at bar, on the other hand, the purported notes totaled the full fair market value of all the assets transferred save for the $1,050 in cash allocated to stock. As for *Perrault,* the transfers there—like the transfers in *Tauber,* and unlike the transfers in the case at bar—resulted in the corporation receiving total assets considerably in excess of the face value of the stock and corporate notes combined; and the court found that the excess was properly allocable to stock. The decision in *Earle* v. *W. J. Jones & Son,* 200 F. 2d 846 (C.A. 9th), upon which petitioner also relies, is distinguishable upon the same grounds.

It is obvious then that none of the above cited cases supports the petitioner's contention that the value of stock may be written up by a method of capitalizing earnings, even though substantially all of the business assets are represented—at full fair market value—by purported notes.

The taxpayer also relies on the decision in *Kraft Foods Co.* v. *Commissioner* (C.A. 2d), decided April 2,

1956 (1956 C.C.H., par. 9428). While we believe that the decision in that case is erroneous, as is shown in the dissenting opinion of Judge Clark, there are many factual differences between the cases which make *Kraft* a distinguishable situation. The principal distinction is that in *Kraft* there was no inconsistency between the purpose of creating a debt and any other purpose which the parties had. Here, as we have seen, the purpose of incorporating the business is at war with the assumption that a true debt was created.

In sum, therefore, we submit that the business assets transferred by the Miller brothers to the corporation constituted, in their entirety, a capital investment, committed to the fortunes of the corporate business. It follows, as the Tax Court held, that no valid debt-creditor relationship arose upon the issuance of the purported notes; and that the no par stock issued to the brothers, purportedly for $1,050 in cash, represents in reality all of the assets transferred to the corporation.[4]

II

Under Section 112 (b) (5) of the 1939 Code, No Gain or Loss Is Recognized as to the Transfer of Partnership Assets to the Corporation

Section 112(b)(5) of the 1939 Code provides in pertinent part that:

> No gain or loss shall be recognized if property is transferred to a corporation by one or more per-

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[4] Petitioner's contention (Br. 42-43), that this amounts to a holding that taxpayer was guilty of fraud with intent to evade tax, scarcely merits comment. Fraud in this context connotes something more than a desire and purpose to minimize or avoid taxes; and is not present where a tax avoidance device is fairly and honestly presented to the taxing authorities and the courts for evaluation.

> sons solely in exchange for stock * * * in such corporation, and immediately after the exchange such person or persons are in control of the corporation; * * *

In the case at bar, as we have seen, all of the assets transferred by the Miller brothers to the corporation are reflected in the stock since they all comprised part of the initial capital investment. It follows that in substance the assets were transferred solely in exchange for stock; and since there is no dispute that the Miller brothers were in control of the corporation immediately after the exchange, Section 112(b)(5) is clearly applicable to the transaction.

Section 112(b)(5) withholds recognition of gain or loss upon exchanges to which it applies; and Section 113(a)(8), *supra,* provides that upon such exchanges the corporation acquires the basis of the transferors. Therefore, the Commissioner correctly eliminated from taxpayer's income the long-term capital gain reported on the transfer of his proportionate share of partnership assets to the corporation.[5]

III

Payments of Principal on the Purported Notes Are, to the Extent of Available Earnings and Profits, Taxable Dividends Under Section 115 (a) of the 1939 Code

Section 115(a) of the 1939 Code provides that *any* distribution made by a corporation to its shareholders

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[5] The taxpayer argues (Br. 47-48) that Section 112 (b)(5) can not apply because the "loans", even if they were not true debt, represented paid-in surplus and that no stock was issued. This is a fallacious contention for, no matter what the capital account shows on the books, the stock was necessarily issued as the only consideration for all the property received by the corporation.

out of earnings and profits constitutes a dividend; and Section 115(b) provides that every corporate distribution *is* made out of earnings or profits to the extent thereof.

Petitioner argues that, even though the notes be held to represent capital investments, payments on the principal thereof can not be dividends, but must be regarded as distributions in partial liquidation. (Br. 51.) This argument is patently unsound. The assets of the corporation are reflected in the stock, not in the notes; and hence purported payments on the notes—whether designated as principal or interest—are simply distributions referable to the stock, received by the stockholders as such.

Here, the distributions in question were not made in redemption of any of the stock.[6] They were simply distributions of earnings and profits, as petitioner concedes (Br. 41-42), to the proprietors of the corporation—the owners and operators of the business. Each of the stockholders continued to have the same stock interest notwithstanding these payments. As such the payments were clearly taxable dividends under Section 115(a) and (b). *Houck* v. *Hinds,* 215 F. 2d 673 (C.A. 10th).

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[6] Even if there had been a redemption of stock, the circumstances would compel the conclusion that it was essentially equivalent to the distribution of a dividend and taxable as a dividend under Code Section 115 (g) (1).

CONCLUSION

For all of the foregoing reasons, we submit that the decisions of the Tax Court were correct and should be affirmed.

Respectfully submitted,

CHARLES K. RICE,
Assistant Attorney General.
LEE A. JACKSON,
HILBERT P. ZARKY,
GRANT W. WIPRUD,
Attorneys,
Department of Justice,
Washington 25, D. C.

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